

Snorkeling in the Deep End: A Closer Look at the Repairs Tax Benefit

Reiterate Rating: BUY | PO: 45.00 USD | Price: 44.18 USD



Equity | 21 August 2019

Repairs Tax Remains Focal Point...but What Will Qualify?

As WTR continues to progress through the approval process for the pending Peoples acquisition, we provide our latest model with slight tweaks to our estimates ahead of a potential order (Management has guided towards an Oct 24th ruling but note there is no statutory timeline for an order in the state). While latest discussions with the company suggest that they continue to work through a potential settlement, we see likelihood of one materializing as limited. That said, pending what we still perceive as a likely close during 4Q, the company plans to host an Analyst Day the first week of December that should provide a broad update for the combined company. We would expect a consolidated EPS range for 2020 and some longer term growth guidance to be provided, as well as potential clarity around sizing the repairs tax benefit opportunity for the gas business. The previously employed strategy consists of two components – a current portion based on qualified capex which can be elected (with the benefit flowing through in the income statement immediately) and a catch up adjustment component to reflect prior investments that are currently capitalized and depreciated for tax purposes. While the company has clearly articulated plans to elect the *current* component, the *catch up* component remains somewhat more of a wildcard given the requirement of a commission order and potential nuances around how it could be treated. In the past, the company was able to amortize the catch-up deduction for the PA water business over a 10-year period of time to provide additional tax relief. That said, we perceive the commission is more likely to give at least some benefit back to customers if enacted now. Nonetheless, we don't see the catch up component as necessary for our base case scenario, particularly given the likelihood of a ramp in capital investments going forward. While quantifying qualified capex remains somewhat more challenging, we continue to suspect robust ability to earn in PA, which makes up around 90% of the gas business.

Valuation: Shifting +\$1/sh to \$46/sh on higher multiple

We shift our '20-22 estimates 1% lower as we assume more conservative ROEs for Peoples Gas. That said, we remain 3% above the Street on '21 given what we still perceive as a robust earnings profile likely to materialize as the company moves to elect the current component post transaction close. On our new estimates and after reflecting the latest mark to market of peer multiples, our price objective shifts up \$1 to \$46.

Estimates (Dec)

(US\$)	2017A	2018A	2019E	2020E	2021E
EPS	1.36	1.41	1.30	1.74	1.75
GAAP EPS	1.36	1.41	1.30	1.74	1.75
EPS Change (YoY)	3.0%	3.7%	-7.8%	33.8%	0.6%
Consensus EPS (Bloomberg)			1.39	1.58	1.67
DPS	0.81	0.86	0.92	0.99	1.06

Valuation (Dec)

	2017A	2018A	2019E	2020E	2021E
P/E	32.5x	31.3x	34.0x	25.4x	25.2x
GAAP P/E	32.5x	31.3x	34.0x	25.4x	25.2x
Dividend Yield	1.8%	2.0%	2.1%	2.2%	2.4%
EV / EBITDA*	1.1x	8.4x	27.3x	17.1x	16.3x
Free Cash Flow Yield*	-1.0%	-1.3%	-1.8%	-1.3%	-0.9%

* For full definitions of *IQmethod*SM measures, see page 7.

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Stock Data

Price	44.18 USD
Price Objective	45.00 USD
Date Established	15-Jul-2019
Investment Opinion	A-17
52-Week Range	32.09 USD - 44.60 USD
Mkt Val (mn) / Shares Out (mn)	9,531 USD / 215.7
Average Daily Value (mn)	51.25 USD
BofAML Ticker / Ex change	WTR / NAS
Bloomberg / Reuters	WTR US / WTR.N
ROE (2019E)	7.5%
Net Dbt to Eqty (Dec-2018A)	127.1%

iQmethodSM – Bus Performance*

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Return on Capital Employed	5.1%	3.9%	4.4%	5.2%	5.1%
Return on Equity	12.6%	9.7%	7.5%	8.6%	8.3%
Operating Margin	41.5%	38.7%	48.1%	70.2%	71.1%
Free Cash Flow	(97)	(127)	(170)	(120)	(87)

iQmethodSM – Quality of Earnings*

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Cash Realization Ratio	1.6x	1.9x	1.9x	1.8x	1.9x
Asset Replacement Ratio	3.5x	3.4x	3.3x	2.6x	2.5x
Tax Rate	6.6%	NM	10.0%	10.0%	10.0%
Net Debt-to-Equity Ratio	108.3%	127.1%	97.0%	100.1%	102.8%
Interest Cover	3.9x	2.8x	3.4x	3.5x	3.3x

Income Statement Data (Dec)

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Sales	805	835	902	949	966
% Change	0.6%	3.7%	8.0%	5.3%	1.7%
Gross Profit	810	838	1,044	1,596	1,657
% Change	-1.3%	3.5%	24.6%	52.9%	3.8%
EBITDA	14,226	1,941	597	953	998
% Change	-33.6%	-86.4%	-69.2%	59.6%	4.8%
Net Interest & Other Income	(88)	(99)	(132)	(194)	(210)
Net Income (Adjusted)	240	192	251	414	416
% Change	2.4%	-19.9%	31.0%	64.5%	0.6%

Free Cash Flow Data (Dec)

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Net Income from Cont Operations (GAAP)	240	192	287	442	446
Depreciation & Amortization	137	147	191	330	356
Change in Working Capital	NA	NA	NA	NA	NA
Deferred Taxation Charge	14	(15)	0	0	0
Other Adjustments, Net	(9)	45	(10)	(26)	(3)
Capital Expenditure	(478)	(496)	(639)	(865)	(885)
Free Cash Flow	-97	-127	-170	-120	-87
% Change	NM	-31.5%	-33.9%	29.8%	27.7%

Balance Sheet Data (Dec)

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Cash & Equivalents	4	4	3	5	5
Trade Receivables	99	101	126	193	200
Other Current Assets	28	42	46	57	58
Property, Plant & Equipment	5,400	5,930	9,103	9,638	10,168
Other Non-Current Assets	801	887	2,462	2,462	2,462
Total Assets	6,332	6,964	11,741	12,355	12,893
Short-Term Debt	117	160	288	310	331
Other Current Liabilities	167	239	258	309	315
Long-Term Debt	2,008	2,398	4,305	4,638	4,955
Other Non-Current Liabilities	2,083	2,158	2,158	2,158	2,158
Total Liabilities	4,375	4,955	7,008	7,415	7,758
Total Equity	1,958	2,009	4,733	4,940	5,135
Total Equity & Liabilities	6,332	6,964	11,741	12,355	12,893

* For full definitions of iQmethodSM measures, see page 7.

Company Sector

Water Utilities

Company Description

Aqua America is a regulated water utility providing water or wastewater services to 3M customers in the states of PA, OH, TX, IL, NC, NJ, IN, and WV, with PA segment being the largest contributor to the NI. In Oct 2018, The company announced acquisition of Peoples Gas, a gas utility providing distribution services to 740,000 customers in PA, WV, and KY. The acquisition is expected to be closed by mid- 2019.

Investment Rationale

We see our Buy rating as supported by meaningfully above Street EPS projections on the back of its pending Peoples Gas business and above average ratebase growth.

Stock Data

Average Daily Volume 1,159,263

Quarterly Earnings Estimates

	2018	2019
Q1	NA	NA
Q2	NA	NA
Q3	NA	NA
Q4	NA	NA

Smoothing Out the Impact: What Would it Look Like

With the election of the repairs tax benefit the company plans to pursue for 2020, earnings will see a large step up as the company expenses capital costs as opposed to depreciating them over a useful life for tax purposes. The magnitude of the initial increase will ultimately be determined by how much of the capital investment program qualifies for the treatment and whether the commission allows the company to use a catch up component for costs that are currently being depreciated. Our sense is that capital investments back to 2012 could potentially be privy to such treatment – albeit investment was likely more muted relative to the current capital plans – and we don't see management relying on such election. We perceive the commission is more inclined to give at least partial benefit of any catch up component back to customers. If management is able to reach an acquisition settlement – which we don't see as likely given the current timeline – that could include a balancing account to help drive more stable earnings growth in a similar mechanism that has been employed by NEE for storms. Alternatively, the company could look to manage capex in a way that accelerates qualified expenses y/y. We see the level of overall eligibility as the more critical question into the transaction's close and the potential Analyst Day later this year.

EPS Estimates

The exhibit below reflects our latest EPS estimates. Our '20-22 estimates shift -1% lower as we assume more conservative ROEs for the Peoples Gas business (albeit still close to 14%). We remain 3% above the street for '21 given what we still perceive as a strong earnings potential from the election of the Repairs Tax Benefit, regardless of the company's ability to capture any benefit from the catch up adjustment. Despite any additional efforts by the company to smooth the impact from the benefit, we perceive a continued upward bias to street estimates.

Table 1: EPS Estimates

EPS Estimates	2019E	2020E	2021E	2022E	2023E
PA	\$0.84	\$0.80	\$0.77	\$0.82	\$0.86
OH	\$0.07	\$0.07	\$0.07	\$0.08	\$0.08
IL	\$0.08	\$0.07	\$0.08	\$0.08	\$0.09
TX	\$0.07	\$0.06	\$0.06	\$0.06	\$0.06
NC	\$0.04	\$0.04	\$0.04	\$0.04	\$0.05
Other States	\$0.08	\$0.08	\$0.09	\$0.09	\$0.10
Water Utility	1.18	1.12	1.11	1.17	1.24
Peoples Gas	0.17	0.68	0.72	0.77	0.81
Parent & Other	-0.05	-0.08	-0.10	-0.12	-0.14
EPS	1.30	1.72	1.73	1.82	1.90
YoY Growth		32%	1%	5%	5%
Shares O/S	193	238	238	250	254
Fully Diluted Shares O/S	221	254	254	254	254
Previous EPS	\$1.30	\$1.74	\$1.75	\$1.84	
Consensus	1.39	1.58	1.67		
Consensus '19-21 CAGR					
BofAML CAGR 2019-2021					
DPS	0.92	0.99	1.06	1.13	1.21
Payout Ratio	71%	57%	61%	62%	64%
Share Count	193	238	238	250	254

Source: BofA Merrill Lynch Global Research, Bloomberg

Valuation: PO Shifts to \$46

The exhibit below reflects our latest SOTP on our new estimates and after marking to market for the latest peer multiples (27.9x vs. 26.2x and 20.7x vs. 21.2x for water and gas, respectively). We continue to apply a 1x discount to Peoples Gas to reflect removal of any sector takeout premium as well as discounting the strong returns we ascribe to it in the near term. Our lower gas contribution and multiple was more than offset by the sharp increase in peer water multiples. Overall, our water valuation shifts up \$3, while lower gas contribution and higher corporate drag are a \$2 headwind relative to our prior valuation. Net net, our PO ultimately shifts up \$1 to \$46.

Table 2: WTR SOTP

Table 2: WTR 501

Water Utilities	2021 EPS		P/E Multiple			Equity Value			
		Peer	Prem/Disc	Low	Base	High	Low	Base	High
Peer Water P/E		27.9x							
Group EPS '18-'22 CAGR		8.30%							
1-year forward group Water multiple		30.2x							
Water Utilities									
States	2021E EPS ROE embedded								
PA	\$0.77	10.0%	0.0x	29.2x	30.2x	31.2x	\$23	\$23	\$24
OH	\$0.07	9.9%	0.0x	29.2x	30.2x	31.2x	\$2	\$2	\$2
IL	\$0.08	9.6%	0.0x	29.2x	30.2x	31.2x	\$2	\$2	\$2
TX	\$0.06	10.0%	0.0x	29.2x	30.2x	31.2x	\$2	\$2	\$2
NC	\$0.04	9.9%	0.0x	29.2x	30.2x	31.2x	\$1	\$1	\$1
Other (including acquisitions)	\$0.09	9.9%	0.0x	29.2x	30.2x	31.2x	\$3	\$3	\$3
Water utilities total (ex-Peoples)	\$1.11			29.2x	30.2x	31.2x	\$32	\$34	\$35
Gas Utilities									
Peer Gas P/E		20.7x							
Group EPS '18-'22 CAGR		5.80%							
Peoples Gas Multiple		21.9x							
	2021E EPS ROE embedded								
Peoples Gas	\$0.72	13.7%	-1.0x	19.9x	20.9x	21.9x	\$14	\$15	\$16
HoldCo Debt									
(50% Netting out Debt) @ Aqua Parent			-738	50%			(\$369)	(\$369)	(\$369)
(50% P/E multiple on Interest Ex p)			4.3%	50%			(\$370)	(\$342)	(\$399)
50/50 Weighted Drag from HoldCo Drag							(\$739)	(\$710)	(\$767)
Fully Diluted Shares Outstanding							254	254	254
PO							\$44.00	\$46.00	\$47.00
Current Price								\$44.42	
Dividend Yield								2%	

Source: BofA Merrill Lynch Global Research, Bloomberg

Price objective basis & risk

Aqua America (WTR)

Our price objective is \$46 based on our SOTP approach, applying a peer multiple to the water utility and gas utility, respectively and accounting for expected growth for each sector. We apply a 1.0x discount to Peoples Gas as we expect earned ROEs to be driven down over time. We net out parent debt and parent interest expense associated with parent debt 50/50 weighed basis.

Specifically, we derive a value of \$34 for the Water Business and \$15 per share for the Gas utilities. We then deduct around \$3 per share related to corp drag, which gives us our PO of \$46.

Risks to the downside are acquisition risk, deteriorating regulatory outcomes, and risks from a lower rating following the diversification into gas.

Analyst Certification

I, Julien Dumoulin-Smith, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Electric Utilities, Alternative Energy & LNG Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	Alliant Energy Corporation	LNT	LNT US	Julien Dumoulin-Smith
	American Electric Power	AEP	AEP US	Julien Dumoulin-Smith
	Aqua America	WTR	WTR US	Julien Dumoulin-Smith
	Atlantica Yield	AY	AY US	Julien Dumoulin-Smith
	CenterPoint Energy	CNP	CNP US	Julien Dumoulin-Smith
	Cheniere Energy Inc	LNG	LNG US	Julien Dumoulin-Smith
	Clearway Energy	CWENA	CWEN/A US	Julien Dumoulin-Smith
	Clearway Energy	CWEN	CWEN US	Julien Dumoulin-Smith
	CMS Energy	CMS	CMS US	Julien Dumoulin-Smith
	Consolidated Edison	ED	ED US	Julien Dumoulin-Smith
	Emera Inc	YEMA	EMA CN	Julien Dumoulin-Smith
	Entergy	ETR	ETR US	Julien Dumoulin-Smith
	Evergy, Inc	EVRG	EVRG US	Julien Dumoulin-Smith
	Exelon	EXC	EXC US	Julien Dumoulin-Smith
	FirstSolar, Inc.	FSLR	FSLR US	Julien Dumoulin-Smith
	FirstEnergy	FE	FE US	Julien Dumoulin-Smith
	Fortis	YFTS	FTS CN	Julien Dumoulin-Smith
	Fortis Inc	FTS	FTS US	Julien Dumoulin-Smith
	NextEra Energy	NEE	NEE US	Julien Dumoulin-Smith
	NRG Energy	NRG	NRG US	Julien Dumoulin-Smith
	Pinnacle West	PNW	PNW US	Julien Dumoulin-Smith
	Sunnova Energy	NOVA	NOVA US	Julien Dumoulin-Smith
	SunRun	RUN	RUN US	Julien Dumoulin-Smith
	Vivint Solar	VSLR	VSLR US	Julien Dumoulin-Smith
NEUTRAL				
	AES	AES	AES US	Julien Dumoulin-Smith
	Algonquin Power & Utilities Corp	AQN	AQN US	Julien Dumoulin-Smith
	Algonquin Power & Utilities Corp	YAQN	AQN CN	Julien Dumoulin-Smith
	Ameren Corporation	AEE	AEE US	Julien Dumoulin-Smith
	Black Hills Corporation	BKH	BKH US	Julien Dumoulin-Smith
	Dominion Energy	D	D US	Julien Dumoulin-Smith
	Edison International	EIX	EIX US	Julien Dumoulin-Smith
	Hannon Armstrong	HASI	HASI US	Julien Dumoulin-Smith
	NextDecade	NEXT	NEXT US	Julien Dumoulin-Smith
	NextEra Energy Partners	NEP	NEP US	Julien Dumoulin-Smith
	OGE Energy Corp	OGE	OGE US	Julien Dumoulin-Smith
	Pattern Energy Group	PEGI	PEGI US	Julien Dumoulin-Smith
	PNM Resources Inc.	PNM	PNM US	Julien Dumoulin-Smith
	Portland General Electric Company	POR	POR US	Julien Dumoulin-Smith
	PPL Corporation	PPL	PPL US	Julien Dumoulin-Smith
	Public Service Enterprise Group	PEG	PEG US	Julien Dumoulin-Smith
	Sempra Energy	SRE	SRE US	Julien Dumoulin-Smith
	Southern Company	SO	SO US	Julien Dumoulin-Smith
	Vistra Energy	VST	VST US	Julien Dumoulin-Smith
	Xcel Energy Inc	XEL	XEL US	Julien Dumoulin-Smith
UNDERPERFORM				
	American Water Works	AWK	AWK US	Julien Dumoulin-Smith
	Avangrid	AGR	AGR US	Julien Dumoulin-Smith
	Avista	AVA	AVA US	Richard Ciciarelli, CFA
	Bloom Energy	BE	BE US	Julien Dumoulin-Smith
	DTE Energy	DTE	DTE US	Julien Dumoulin-Smith
	Duke Energy	DUK	DUK US	Julien Dumoulin-Smith
	Eversource Energy	ES	ES US	Julien Dumoulin-Smith
	Hawaiian Electric Industries	HE	HE US	Julien Dumoulin-Smith
	Idacorp	IDA	IDA US	Julien Dumoulin-Smith
	NorthWestern Corporation	NWE	NWE US	Julien Dumoulin-Smith
	SunPower Corp.	SPWR	SPWR US	Julien Dumoulin-Smith
	Terraform Power	TERP	TERP US	Julien Dumoulin-Smith
	Unitil Corporation	UTL	UTL US	Julien Dumoulin-Smith
	WEC Energy Group Inc	WEC	WEC US	Julien Dumoulin-Smith
RSTR				
	El Paso Electric Company	EE	EE US	Julien Dumoulin-Smith

US - Electric Utilities, Alternative Energy & LNG Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
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iQ_{method}SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQ_{method}SM is the set of BofA Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and valuations. The key features of *iQ_{method}* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

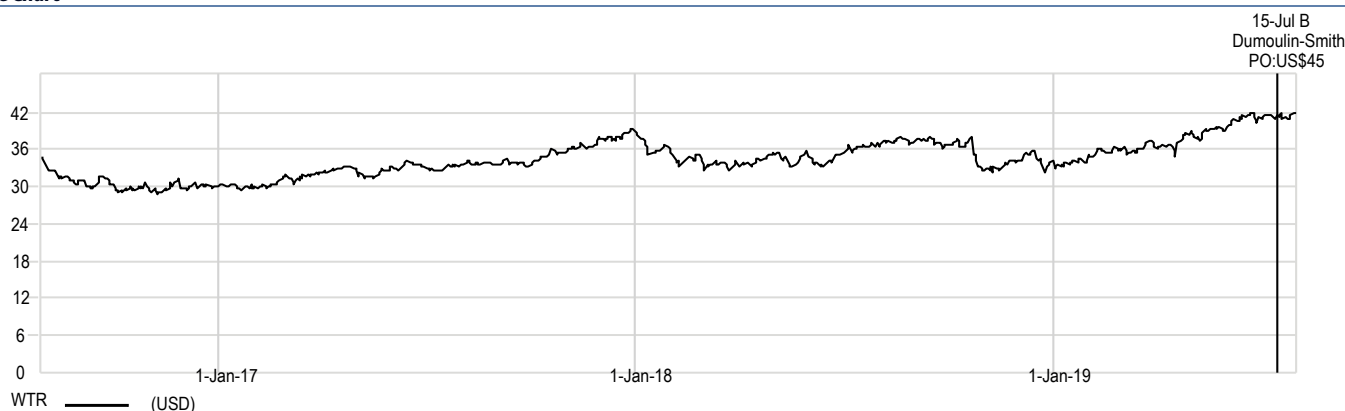
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Disclosures

Important Disclosures

WTR Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of July 31, 2019 or such later date as indicated.

Equity Investment Rating Distribution: Utilities Group (as of 30 Jun 2019)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	61	44.20%	Buy	47	77.05%
Hold	42	30.43%	Hold	30	71.43%
Sell	35	25.36%	Sell	27	77.14%

Equity Investment Rating Distribution: Global Group (as of 30 Jun 2019)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1516	51.23%	Buy	942	62.14%
Hold	687	23.22%	Hold	431	62.74%
Sell	756	25.55%	Sell	380	50.26%

* Issuers that were investment banking clients of BofA Merrill Lynch or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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